

MEMORANDUM

_____, 2002

TO: AIRPORT COMMISSION
Hon. Henry E. Berman, President
Hon. Larry Mazzola, Vice President
Hon. Michael S. Strunsky
Hon. Linda S. Crayton
Hon. Caryl Ito

FROM: Airport Director

SUBJECT: Airport Commission Interest Rate Swap Policy

DIRECTOR'S RECOMMENDATION: ADOPT RESOLUTION APPROVING NEW AIRPORT COMMISSION INTEREST RATE SWAP POLICY

I recommend that the Commission adopt the attached resolution approving an Airport Commission interest rate swap policy. This policy will guide the Commission's finance team (staff, financial advisors, legal counsel) in the development and implementation of future interest rate swaps and related transactions. To date, the Commission has not entered into any interest rate swaps.

Background

Barron's Financial Guidelines defines an interest rate swap as "an arrangement whereby two parties (called counterparties) enter into an agreement to exchange periodic interest payments." The payments are based on a fixed principal amount, called the "notional amount" because no principal amount is actually exchanged between the parties; only interest is exchanged. In a typical interest rate swap, one party pays interest on the notional amount at a variable or "floating" rate, which fluctuates over time. The other party pays interest on the notional amount at a fixed rate for the life of the swap. The fixed rate is either bid or negotiated as the swap is executed. Swaps can be negotiated for a variety of terms and are generally not less than 2 years and not more than 30 years.

Objectives in the Use of Interest Rate Swaps

Properly used, interest rate swaps, and related financial instruments such as swap options, can be beneficial interest rate management tools that can assist the Commission as part of its overall debt and investment management program. Interest rate swaps are appropriate for use when they are designed to achieve specific financial objective(s) consistent with the Commission's overall financial policy and strategy. Swaps may be used to lock-in current market fixed interest rates, or to effectively create a variable interest rate portion of the Commission's debt portfolio. As a result, swaps can be implemented with the objective of:

- Producing net interest rate savings;
- Generating increased net investment returns;
- Altering the pattern of debt service payments;
- Capping or hedging variable interest rate payments, or
- Providing a better match between the interest rates on the Commission's debt and investments.

Interest rate swap options ("swaptions") granting the right to another party to commence or cancel an interest rate swap with the Commission may be used to the extent that the underlying swap is consistent with the Commission's financial policy.

Inappropriate Use of Interest Rate Swaps

There are financial risks involved in the use of interest rate swaps. When used improperly, interest rate swaps or other related financial instruments may expose the Commission to undue risk. There are situations when the use of interest rate swaps or related financial instruments are inappropriate, and should not be permitted. These include:

1. When a swap or related financial instrument is used for speculative purposes, such as potential trading gains, rather than for managing and controlling interest rate risk in connection with the Commission's debt and investment portfolios;
2. When a swap or related financial instrument creates extraordinary leverage or financial risk;
3. When the Commission does not have sufficient liquidity to terminate the swap at current market rates; and
4. When there is insufficient price "transparency" to permit the Commission and its advisors to reasonably value the instrument, as a result, for example, of the use of unusual structures or terms.

The attached Commission policy governing the use of interest rate swaps and related instruments prohibits the use of these instruments in the above situations, requires the Airport Director to identify and evaluate any financial risks for the Commission, and to develop risk mitigation measures prior to requesting the approval of any swap or related transaction.

I recommend approval of the attached resolution adopting an Airport Commission Interest Rate Swap Policy.

John L. Martin
Airport Director

Prepared by: Bob Rhoades

AC interest rate swap policy

AIRPORT COMMISSION OF THE CITY AND COUNTY OF SAN
FRANCISCO
INTEREST RATE SWAP POLICY

WHEREAS, the Commission has a debt portfolio that includes approximately \$4.35 billion in long-term, fixed-rate bonds and an investment portfolio with the City Treasurer and the bond trustees that at times exceeds \$400 million; and

WHEREAS, the Commission may benefit from the use of interest rate swaps, swap options and related instruments as part of its overall debt and investment management program; and

WHEREAS, prudent debt and investment management practice supports the establishment by the Commission of an Interest Rate Swap policy that establishes parameters for the proper use of interest rate swaps and related financial instruments that will guide the Airport Director in the development and implementation of any future interest rate swap and related transactions; now, therefore, be it

RESOLVED, That this Commission hereby adopts the Interest Rate Swap Policy set forth below governing the use of interest rate swaps, swap options, and related financial instruments, as part of the Commission's overall debt and investment management program; and be it further

RESOLVED, That this Commission hereby delegates responsibility for the implementation and operation of the Commission's interest rate swap program to the Airport Director, within the parameters set forth below, who shall establish written procedures and internal controls consistent with the Interest Rate Swap Policy.

AIRPORT COMMISSION INTEREST RATE SWAP POLICY

1. Introduction

The purpose of this document is to identify various policies and procedures that will govern the Commission's implementation of any "interest rate swaps," "swap options" and related transactions.

As background, both the Commission's debt portfolio and its investment portfolio involve a variety of interest rate payments and interest rate risks. A variety of financial instruments are available to offset, hedge, or reduce those interest rate risks.

2. Scope

This Interest Rate Swap Policy applies to any interest rate swap or swap option or related transaction that the Commission may undertake.

3. Authorizations and Approvals; Compliance with Bond Documents

The Airport Director must obtain the approval of the Commission prior to entering into any interest rate swap, swap option or related transaction. In certain instances, the approval of the City and County of San Francisco's Board of Supervisors also will be required in accordance with the City's Charter. In addition, a certification may be required from the City's Controller pursuant to the City's Charter.

The Airport Director shall determine whether a proposed swap agreement complies with any applicable provisions of the Commission's bond resolutions and agreements with respect to its outstanding debt.

4. General Objectives

The Commission may execute an interest rate swap, swap option or related transaction only if the transaction can be reasonably expected to achieve one or more of the following objectives:

- Result in a lower net cost of borrowing with respect to the Commission's debt, or achieve a higher net rate of return on the investment of Commission moneys.
- Reduce exposure to changes in interest rates either in connection with a particular debt financing or investment transaction or in the management of interest rate risk with respect to the Commission's overall debt and investment portfolios.

5. Prohibited Uses of Interest Rate Swaps and Related Instruments

The Commission shall not execute interest rate swaps agreements or related instruments under the following circumstances:

- When a swap or other financial instrument is used for speculative purposes, such as potential trading gains, rather than for managing and controlling interest rate risk in connection with Commission debt or investments;
- When a swap or other financial instrument creates extraordinary leverage or financial risk;
- When the Commission lacks sufficient liquidity to terminate the swap at current market rates; or
- When there is insufficient price “transparency” to permit the Commission and its advisors to reasonably value the instrument, as a result, for example, of the use of unusual structures or terms.

6. Permitted Financial Instruments

The Commission may utilize the following financial products, on a either current or forward basis, after identifying the objective(s) to be realized and assessing the attendant risks:

- Interest rate swaps, including fixed, floating and/or basis swaps
- Interest rate caps, floors and collars
- Options, including on swaps, caps, floors and/or collars and/or cancellation or index-based features

7. Identification and Evaluation of Financial and Other Risks

Prior to obtaining Commission authorization to implement an interest rate swap, swap option or related transaction, the Airport Director shall identify and evaluate the financial risks involved in the transaction, and summarize them clearly and concisely for the Commission, along with any measures that will be taken to mitigate those risks. The types of questions that should be evaluated in connection with the identification and evaluation of financial risks shall include:

- Market or Interest Rate Risk: Does the proposed transaction hedge or create exposure to fluctuations in interest rates?
- Tax Law Risk: Is the proposed transaction subject to rate adjustments, extraordinary payments, termination or other adverse consequences in the event of a future change in Federal income tax policy?
- Termination Risk: Under what circumstances might the proposed transaction be terminated (other than at the option of the Commission)? At what cost? Does the Commission have sufficient liquidity to cover this exposure?

- Risk of Uncommitted Funding (“Put” risk): Does the transaction require or anticipate a future financing(s) that is dependent upon third party participation? What commitments can be or have been secured for such participation?
- Legal Authority: Is there any uncertainty regarding the legal authority of any party to participate in the transaction?
- Counterparty Credit Risk: What is the creditworthiness of the counterparty? What provisions have been made to mitigate exposure to adverse changes in their credit standing?
- Ratings Risk: Is the proposed transaction consistent with the Commission’s current credit ratings or its desired future ratings and with related rating agency policies?
- Basis Risk: Do the anticipated payments that the Commission would make or receive match the payments that it seeks to hedge?
- Tax Exemption on Commission Debt: Does the transaction comply with all Federal tax law requirements with respect to the Commission’s outstanding tax-exempt bonds?
- Accounting Risk: Does the proposed transaction create any accounting issues that could have a detrimental effect on the Commission’s financial statements? Would the proposed transaction have any effect on the Commission’s rate covenant calculation or compliance? How are any such effects addressed?
- Administrative Risk: Can the proposed transaction be readily administered and monitored by the Commission’s finance team consistent with the policies outlined in the Commission’s Interest Rate Swap Policy?
- Subsequent Business Conditions: Does the proposed transaction or its benefits depend upon the continuation or realization of specific industry or business conditions?

8. Anticipated Savings from Synthetic Fixed Rate Advance Refundings

Forward interest rate swaps are utilized in refunding bond transactions in combination with variable rate debt to achieve debt service savings. These transactions are sometimes referred to as “synthetic fixed rate advance refundings.” Such transactions should be anticipated to generate at least five percent (5%) net present value savings when compared to the notional amount of the swap, as determined by the Commission’s finance team. Remarketing, credit and liquidity fees should be added in determining net debt service costs of the refunding. This threshold will serve as a guideline and will be subject to amendment by the Commission should the transaction, in the Commission’s sole judgment, help to meet any of the other objectives outlined herein.

9. Form of Swap Agreements

Each interest rate swap executed by the Commission shall contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement, including the Schedule to the Master Agreement and a Credit Support Annex, as supplemented and amended in accordance with the recommendations of the Commission’s finance team. The swap agreements between the Commission and each

qualified swap counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the Airport Director and City Attorney deem necessary or desirable.

10. Qualified Swap Counterparties

The Commission shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. Qualified swap counterparties (or their guarantors) must be rated no less than “Aa3” or “AA-” by one of the nationally recognized rating agencies (i.e., Moody’s, Standard and Poor’s, or Fitch), and no less than “A2” or “A” by the other rating agencies. In addition, the counterparty must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. Each counterparty shall have a minimum capitalization of at least \$250 million.

11. Procurement Process

The Commission may either negotiate or competitively bid its interest rate swap transactions. At this time, it is the Commission’s intention to pre-qualify swap counterparties through a request for qualifications process, and then conduct a competitive bid process among a group of pre-qualified swap counterparties.

12. Termination Provisions and Commission Liquidity

Optional Termination: All interest rate swap transactions shall contain provisions granting the Commission the right to optionally terminate a swap agreement at anytime over the term of the agreement. In general, exercising the right to optionally terminate an agreement produces a benefit to the Commission, either through receipt of a payment from a termination, or if a termination payment is made by the Commission, in connection with a corresponding benefit from a change in the related Commission debt or investment, as determined by the Commission. The Airport Director, as appropriate, in consultation with the Commission’s finance team, shall determine if it is financially advantageous for the Commission to terminate a swap agreement.

Mandatory Termination: A termination payment to or from the Commission may be required in the event of termination of a swap agreement due to a default by or a decrease in the credit rating of either the Commission or the counterparty. Prior to entering into the swap agreement or making any such termination payment, as appropriate, the Airport Director shall evaluate whether it would be financially advantageous for the Commission to enter into a replacement swap as a means of offsetting any such termination payment. Any such swap would be subject to Commission and other approvals as set forth herein.

Any swap termination payment due from the Commission shall be made from available Commission monies. The Airport Director shall report any such termination payments to the Commission at the next Commission meeting.

Available Liquidity: The Commission shall consider the extent of the its exposure to termination payment liability in connection with each swap transaction, and the availability of sufficient liquidity to make any such payments that may become due.

13. Term and Notional Amount of Swap Agreement

The Commission shall determine the appropriate term for an interest rate swap agreement on a case-by-case basis. The slope of the interest rate swap curve, the marginal change in swap rates from year to year along the swap curve, and the impact that the term of the swap has on the overall exposure of Commission shall be considered in determining the appropriate term of any swap agreement. For any swap agreement entered into in connection with the issuance or carrying of bonds, the term of such swap agreement shall not extend beyond the final maturity date of such bonds.

The Commission shall not enter into any swap agreement that would cause the aggregate notional amount of all of the Commission's swaps to exceed 10 percent of the aggregate principal amount of the Commission's outstanding general airport revenue bonds. This threshold shall be reviewed on an annual basis, and may be amended by the Commission from time to time.

14. Swap Counterparty Exposure Limits

In order to diversify the Commission's counter-party credit risk and to limit the Commission's credit exposure to any one counterparty, the following limits are established on termination exposure to any one counterparty. These limits shall only apply as of the time a swap or related transaction is entered into, and thus may be exceeded during the term of a swap or swaps with the same counterparty. The Commission may make exceptions to these limits to the extent that the execution of a swap achieves one or more of the objectives outlined herein. These limits shall be reviewed periodically by the Commission and adjusted as appropriate.

For purposes of these limits, "Maximum Net Termination Exposure" shall be an amount equal to the aggregate maximum reasonably anticipated net termination payment exposure for all of the Commission's existing and proposed swap agreements with such counterparty, as determined by the Commission's finance team. There are separate limits for collateralized, non-collateralized and total termination payment exposure. The limits vary based upon the credit rating of the counterparty. If the counterparty has more than one rating, the lowest rating will govern for purposes of calculating the permissible levels of exposure. The limitations are as follows:

Counterparty Credit Ratings	Maximum Collateralized Net Termination Exposure	Maximum Uncollateralized Net Termination Exposure	Maximum Total Net Termination Exposure
AAA Category	\$40 million	\$40 million	\$40 million
AA Category	\$40 million	\$10 million	\$40 million
Below AA	\$30 million	None	\$30 million

If any exposure limit is exceeded by a counterparty during the term of a swap agreement, the Airport Director shall consult with the Commission's finance team regarding appropriate strategies, if any, to mitigate this increased exposure.

15. Swap Aggregate Maximum Net Termination Exposure

As of the date of execution of any swap agreement or related instrument, the aggregate maximum reasonably anticipated net termination payment exposure for all of the Commission's existing and proposed swap agreements, as determined by the Commission's finance team, shall not exceed the sum of 1) the funds available in the Commission's Contingency Account plus 2) the Commission's then available unutilized capacity (but not to exceed \$100 million) under its Commercial Paper Program.

16. Collateral Requirements

As part of any swap agreement, the Commission may require collateralization or other credit enhancement to secure any or all swap payment obligations of the counterparty. As appropriate, the Airport Director may require collateral or other credit enhancement to be posted by each swap counterparty under the following circumstances:

- Each counterparty may be required to post collateral if the credit rating of the counterparty or its guarantor falls below the "AA" category from all three of the nationally recognized rating agencies (Moody's, Standard & Poor's and Fitch). The amount of collateral posted shall be equal to the positive termination value of the swap agreement to the Commission from time to time.
- Collateral shall consist of cash, U.S. Treasury securities and U.S. Agency securities.
- Collateral shall be deposited with a custodian, acting as agent for the Commission, or as mutually agreed upon between the Commission and each counterparty.
- A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of the swap agreement with each swap counterparty.
- The market value of the collateral shall be determined on at least a monthly basis.
- The Commission will determine reasonable threshold limits for the initial deposit and for increments of collateral posted thereafter.

- The Airport Director shall determine on a case-by-case basis whether other forms of credit enhancement are more beneficial to the Commission.

In connection with any collateralization requirements that may be imposed upon the Commission in connection with a swap agreement, the Commission may post collateral or it may seek to obtain swap insurance in lieu of posting collateral. The Airport Director shall recommend a preferred approach to the Commission on a case-by-case basis.

17. Reporting Requirements

The Commission's finance team will monitor any interest rate swaps that the Commission enters into on at least a weekly basis.

The Commission's finance team will provide a written report to the Commission regarding the status of all interest rate swap agreements at least on a quarterly basis and shall include the following information:

- Highlights of all material changes to swap agreements or new swap agreements entered into by the Commission since the last report.
- Market value of each of the Commission's interest rate swap agreements.
- The net impact to the Commission of a 25 basis point movement (up or down) in the appropriate swap index or curve.
- For each counterparty, the Commission shall provide the total notional amount position, the average life of each swap agreement, the available capacity to enter into a swap transaction, and the remaining term of each swap agreement.
- The credit rating of each swap counterparty and credit enhancer insuring swap payments, if any.
- Actual collateral posting by each swap counterparty, if any, under each swap agreement and in total by that swap counterparty.
- A summary of each swap agreement, including but not limited to the type of swap, the rates and dollar amounts paid by the Commission and received by the Commission, and other terms.
- Information concerning any default by a swap counterparty under a swap agreement with the Commission, and the results of the default, including but not limited to the financial impact to the Commission, if any.
- A summary of any planned swap transactions and the projected impact of such swap transactions on the Commission.
- A summary of any swap agreements that were terminated.

18. Swaps Accounting Treatment

The Commission shall comply with any applicable accounting standards for the treatment of swaps and related financial instruments. The Commission's finance team and the Commission's external auditors shall implement the appropriate accounting standards in consultation with the City Controller.

19. Annual Review of Interest Rate Swap Policy

The Airport Director shall review the Commission's swap policy on an annual basis and recommend appropriate changes to the Commission.